

Development vs Debt: Past and Future

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This paper will deal in turn with the past, the present and the future. My research on the past concerns, in part, how Latin America got out of the mess the last time around, in the 1930s and 1940s. My research on the present deals with the secondary market for LDC debt, in particular the information conveyed by the market prices and its relevance for policy.

For the future, aside from these lessons, I shall discuss the impact of recent events in Eastern Europe on the prospects for Latin America. Here I have been involved since September in chairing a group of academic advisers to the European Commission on the programme of aid for the restructuring of the Hungarian and Polish economies.

Dealing with Debt in the 1930s

A few months ago, I completed a research project for the World Bank, jointly with Barry Eichengreen of Berkeley and CEPR, on dealing with debt in the 1930s and 1980s. Perhaps some of our conclusions should have influenced policy in the 1980s but were too late — nevertheless, I think they are still relevant.

First, we found that countries which interrupted service on their external debts in the 1930s recovered more quickly from the Great Depression than did countries that resisted default. It is of course difficult to isolate how debt management strategy affects subsequent macroeconomic performance. In the 1930s as in the 1980s, maintaining debt service was often associated with fiscal austerity, import compression, and export subsidies. Conversely, the decision to suspend payments was often accompanied by the currently unfashionable policies of fiscal expansion, monetary reflation, and import-substituting industrialisation.

This comprehensive reorientation of macroeconomic stance makes it hard to distinguish the effects of external debt management from the entire set of policies. And we would certainly not recommend that countries now considering debt service reduction should couple it with irresponsible fiscal and monetary policies or inward-looking trade strategies.

Nevertheless, history does suggest that default may be good for you. If creditors are not going to grant outright debt relief, despite the excellent advice they get from middleweights like me and indeed Mr Brady

(Mr Volcker is evidently a heavyweight), perhaps the debtors will finally draw the necessary conclusions.

Such conclusions are reinforced by the evidence that countries that defaulted in the 1930s did not suffer inferior access to the capital markets after the war. The important condition was to conclude negotiated settlements with the creditors. Once they had done that, countries which previously had suspended debt service were treated by the capital market just as countries that had maintained debt service without interruption.

Unlike experience since 1982, interwar default in some cases led to a substantial reduction of transfers from debtor to creditor. We might call this 'selective debt relief'. It was in fact compatible with a reasonable overall rate of return for creditors. The risk premium they had charged *ex ante* was enough to give them average realised rates of return in excess of yields on British and US Treasury bonds.

Now, we observe that the banks have made very substantial provisions for losses and nevertheless survive. This suggests that *ex post*, they too might find that their 1970s lending to LDCs was not unprofitable, even if there were major defaults tomorrow.

Our historical research shows that readjustment of defaulted debts in the 1930s and 1940s typically involved long, complex negotiations. We often hear the analogy with Chapter 11 corporate bankruptcy proceedings in the United States, under which default and readjustment permit a clean break with the past. This analogy is not more applicable to the 1930s than to the 1980s and 1990s. In many cases, interruptions to debt service were sporadic, and uncertainty over transfers lingered for decades. So in this regard, looking to the 1930s for more effective procedures will not help.

On the other hand, we did learn something potentially useful about government behaviour. The standard story of the 1930s is that creditor governments then refrained from involvement in the crisis much more than governments and the international financial institutions do today. We found, however, that creditor-country governments were often intimately involved in interwar debt readjustment. The difference is that in recent years creditor-country governments and their agents have exerted continuous pressure on the debtors to maintain debt service. In the 1930s and 1940s, by contrast, they pressured debtors and

creditors alike.

History offers no encouragement to those who may still believe that some comprehensive plan will sort out the debt crisis in the 1980s. Global schemes to short-circuit protracted bilateral negotiations proved fruitless in the 1930s. Nearly every element of the global plans advocated in the 1980s was first suggested and discussed in international meetings over 50 years ago: a special international lending facility, matched injections of private and public funds, conversion of existing assets into new ones featuring different contingencies. Ultimately none of the global schemes could solve the issues of who should fund and control their administration.

Finally, unlike global plans, market-based debt reduction did make a useful contribution to resolving the debt crisis of the 1930s. Debt buybacks by the debtors reduced the debt overhang and eliminated marginal creditors. Secondary market prices were influenced mainly by changes in the prospects for a negotiated settlement. Buybacks did raise market prices, but nowhere near enough to nullify their effects in reducing the market value of outstanding debt. Moreover, despite their public statements of disapproval, creditors were willing privately to welcome buybacks out of reserves as a part of the readjustment process.

The Secondary Market for Debt

These remarks on buybacks in the 1930s lead me directly to the secondary market for LDC debt today and its relevance for policy. Does the market offer a sensible way out from under the burden of debt?

The fundamental question here is what the market prices mean, what information they contain. It is clear that the discounts in the secondary market represent an inefficiency. Any discrepancy between the market and the nominal value of the debt is in itself a source of inefficiency.

My collaborator Daniel Cohen has put it this way: to all investors in the world, except one, purchasing one dollar of nominal claims on Chile costs (right now) 63 cents. The exception is Chile itself. When Chile repays its debt it has to pay a full dollar for one dollar of principal or one dollar of interest falling due. Basic economics tells us that any price discrepancy like this is inefficient and distorts incentives.

A second source of inefficiency arising from an excessive nominal debt burden is reflected in the secondary market price. This is the 'debt overhang' illustrated by the so-called 'debt Laffer curve'. When the nominal value of the debt is zero, the lenders expect to receive nothing. When the debt approaches infinity, they will expect to receive nothing too: either the debtor will default or the domestic economy will collapse totally and the return on the debt will be

negligible.

So we can suppose there is a smooth curve relating the total present value of expected repayments to the nominal value of the debt: it starts at zero, first increases with the nominal value to some maximum, then starts to fall, ultimately to zero — just as the Laffer curve is supposed to relate total tax revenue to the tax rate.

The debt Laffer curve is in fact reflected in the secondary market price, if the market prices debt efficiently. For in that case, the price is just the present value of expected repayments divided by the nominal value outstanding. So it is the average value of a dollar of nominal debt. If the elasticity of the market price with respect to the face value of the debt exceeds unity, then lenders will actually increase the market value of their claims by writing off some of the debt. If the elasticity is less than unity, then debtors can reduce the market value of their debt through buybacks.

This is an empirical question of great practical relevance. For example, buybacks such as those endorsed by the Brady initiative have been called a 'boondoggle' for creditors. The argument is that they will just transfer resources from the World Bank or the IMF, or from debtor country reserves, to the banks selling debt, without any effective reduction in the aggregate market value of debt outstanding.

Other policy questions also revolve around what information is conveyed by the secondary market price and how it reacts to behaviour by the debtor and creditors. For example, does the market price give an appropriate benchmark for the price at which banks should concede debt reduction? Or for the price at which the debtor or an international agency should be willing to purchase the debt? Is the price for a given country's debt determined mainly by its own economic performance, or is it dominated by overall market conditions and contagion effects?

Work that I have been doing with Daniel Cohen throws some light on these key issues. Our preliminary results relate to monthly market price quotations for the debt of 24 countries, from February 1986 to November 1989. First, we find that the price of debt in the secondary market does not behave like the price of other assets, such as equity shares. In particular, the returns to a holder of debt do not appear to be significantly correlated to any measure of risk. One inference is that the market does not price efficiently.

Second, the prices are very closely correlated — indeed, with unit elasticity — to LIBOR. This suggests that the market price does embody information about the net present value of expected returns to holders of the debt.

Third, the prices for a large debtor, such as Mexico, are very significantly correlated to the weighted mean of prices for other countries and not significantly

correlated to the price of its main export, petroleum. This suggests there is an important systemic risk that is poorly correlated to a country's wealth. On the other hand, for smaller debtors such as Ecuador, the price of oil is a major determinant of the secondary market price.

This indicates a hierarchy of debtors. The large ones determine systemic risks, while for the small debtors, the market price depends on their wealth.

This last set of results illuminates the potential role of buybacks in getting out from under the debt overhang. To the extent that systemic risk is an important determinant of the price, buybacks that reduce the total nominal value will not significantly affect the average value, that is, the market price. Equivalently, the marginal price may be much closer to the average price than critics of buybacks have maintained. The case for buybacks by the debtors in the market is then much stronger.

Latin America and Eastern Europe

But the future for highly indebted Latin American countries will depend not only on what they can do for themselves, whether in their debt strategies or in changing the fundamentals that determine economic performance. The East European revolutions of 1989 may have a major impact.

Debt is important because growth depends on investment. Debt service depresses domestic investment and discourages foreign direct investment. The transformation of Eastern Europe might weaken industrial country efforts to reduce the debt burden on Latin America, and it might also divert foreign direct investment that would have come to Latin America.

Poland of course preceded Mexico in launching the debt crisis with a moratorium just over nine years ago. In writing about East European debt in 1977, I had predicted this and also the danger for Hungary, which then also had to seek assistance in early 1982.

Now these countries are among the most heavily indebted in the world — \$20 bn for Hungary's 10 mn people, \$40 bn against Poland's less than 8 bn of convertible currency exports. By the end of 1989, Poland's annual inflation rate had reached about 1000 per cent, a respectable level even by Latin American standards. Bulgaria, Czechoslovakia, East Germany and Romania are not heavily indebted, but as in Hungary and Poland, much of their capital stock is hopelessly uneconomic.

Many billions of dollars will be needed for reconstruction in Eastern Europe. Some will doubtless come from domestic savings. But the demand for a net inflow of resources is already strong and vocal. This could come from grants, debt reduction for Hungary and Poland, new lending, or foreign direct investment.

There will be some grant element in aid, and given the budgetary constraints of which all industrial countries are only too conscious, this must partly divert resources from aid to Latin America.

The position on debt relief is by no means so clear. Although Hungary has so far resisted rescheduling, at great cost, the market discount is finally beginning to open up. Hungary is likely to be a candidate for Brady treatment after the elections of 24 March, and Poland is already. The political pressure to grant them debt relief may become overwhelming.

This could benefit Latin America. The banks' emphasis on the case-by-case approach reflects resistance to setting precedents; thus Mexico is claimed to be unique. A few more, like Hungary and Poland, could break down that barrier.

The Paris Club has ruled out debt reduction except for the poorest countries. Here again, pressure to help Poland might eventually bring the exception that could become the rule.

This is the optimistic side. The negative aspect is that Eastern Europe is drawing the attention and the resources of the international lending agencies as well as of private investors. Latin American countries may well envy the amounts of official assistance already promised or said to be likely. True, the banks are unlikely to lend significantly, and even official sources should hesitate to put substantial new money into overindebted countries like Hungary and Poland. But the World Bank will clearly lend heavily and also seek co-financing with private investors.

Everyone is calling for foreign direct investment in Eastern Europe, partly to reinforce the movement towards capitalist market economies there. But FDI to the LDCs from OECD countries has been running at a rate less than \$15 bn annually for the past few years — only 10 per cent of total OECD FDI. So Eastern Europe will be more competition for a rather small pot, which it is unlikely to enlarge significantly.

Moreover, the East Europeans may increase the pressure of 'tax competition' for FDI. Mexico now claims to offer the best conditions for foreign private investors in the world. East European countries may try to match the tax breaks, and they will compete favourably in regard to skilled labour at low real wages.

They will also compete in goods markets with the industrialising Latin American countries. Both in patterns of actual and potential trade, and in what they offer to FDI, the East European countries will look to Western Europe, the US and Japan like middle-income developing countries. Incidentally, this is also likely to be uncomfortable for Southern Europe — in particular the Southern tier of the European Community. If Eastern Europe does turn out to be the 'boom town', the 'gold rush' that some

have called it, the Latin American countries will not be the only ones to lose out.

Overall, the balance does not look favourable for Latin America. The way forward is thus somewhat more difficult. My own view is that progress will require more aggressive action to achieve debt relief,

including more active use of the secondary market. But this must go hand in hand with more widespread, determined efforts for domestic economic reforms, of which Mexico is for the most part a good example. After Brady, the initiative must be taken by the Latin American countries themselves.